Lies, Damn Lies and Cash Costs (II)

Costs that don't include all of the costs are not much use the investor. That's why we don't like EBITDA multiples and, as explained in Lies, Damn Lies and Cash Costs, we don't like 'cash costs' as presented widely in the mining game.

Here's a new one on us, though. What about costs that include negative revenues? Never heard of that one before? Well, neither had we until we started looking at 'cash costs' in more detail.

Zinc and lead producer **Perilya** operates the historic Broken Hill mine in NSW and has had a good week, with its major Chinese shareholder making a takeover at a 59% premium to last Friday's share price (sorry Value Fund investors we don't own any).

The 2012 annual report shows cash costs of US$0.62 per pound of zinc sold, and an average price received of $US 0.88. This is an apparent operating margin of 30%, not too bad for a miner during lean times.

So what gives? Well firstly the cash cost excludes a vast amount of sustaining capital expenditure along the lines of what we discussed in the last blog. Secondly the treatment of lead and silver by-product credits is badly inflating the margin. Let's have how they arrive look at the published numbers.

US$/lb of zinc	2012
Direct cash costs (a)	1.27
By-product credits (b)	(0.90)
Zinc treatment charges	0.25
Net cash cost (a+b+c)	**0.62**
Zinc treatment charges	0.25
Price received	0.88
Profit per pound	0.26

Back when I studied accounting, revenue was money you received and costs related to money you paid out. Not so in the mining game. The value of the lead and silver produced (which just happen to be worth more than the zinc) are negative costs, not revenues.

This might seem somewhat irrelevant. Who cares whether you take it off the costs or add it to the revenue? You surely end up with the same amount of profit?

True, but it can be very deceptive. The uninitiated might look at Perilya's cash cost of $0.62, compare it with the price received of $0.88 and assume the zinc price can fall 30% before the mine becomes unprofitable.

But if you count money received as revenue and money paid as costs, you will see that the margins are much tighter than that.

US$/lb of zinc	2012
Zinc	0.88
Silver and lead	0.90
Total revenue	**1.78**
Direct cash costs	1.27
Zinc treatment charges	0.25
Total costs	**1.52**
Cash profit	0.26
Margin	14.6%

The 30% buffer is a furphy. If the weighted average prices for Perilya's three commodities were to fall just 15%, the mine is loss making even at the cash cost level.

We've picked on Perilya because is a nice example, not because it is unique. This practice is rife across the mining industry and another potential pitfall for prospective investors to be wary of.

Note: We use the term 'investor' liberally. The more work we do the more we wonder whether investing in mining stocks automatically qualifies as speculation?